

## Why is Price Discovery in Credit Default Swap Markets News-Specific?

by Ian Marsh and Wolf Wagner

A key interest of the finance profession is in understanding how new information is incorporated into securities prices. One approach is the study of *price discovery* across markets. If new information is simultaneously priced into different markets, this is evidence of informational efficiency. Evidence of one market pricing information faster than another by contrast suggests market inefficiencies.

The idea in this paper is that price discovery may in fact be news-specific. Traders in different markets may not be universally informed or uninformed. Rather, traders choosing to operate in one market may have an advantage (or disadvantage) with respect to one type of information but not necessarily with respect to other innovations. This could cause price discovery not to be unconditionally in favour of one market but to depend upon the type of innovation.

We focus our analysis on price discovery in equity and CDS markets. We find that equity returns lead CDS price changes. However, we find that the CDS-lag is due to *common* (and not firm-specific) news and arises predominantly in response to *positive* (instead of negative) equity market news.

What can account for the news-specific nature of price discovery? We bring forward an explanation based on different investor groups being important in the two markets. While a wide range of investors with very diverse trading interests are active in equity markets, participation in the CDS market is much more limited. A key reason for the development of CDS markets was institutional investors' demand (predominantly by banks) for an instrument capable of hedging credit risks. The prevalence of hedgers in CDS markets can explain both the aggregate-idiosyncratic news and the positive-negative news asymmetries. As these investors are probably well informed about news specific to the firms in their portfolio, CDS markets respond efficiently to such news. However, hedgers of firm risks are likely to focus less on macro-news. In response to positive equity market news dealers in the CDS market can thus keep prices high and exploit their informational advantage. This dampens price adjustment in the CDS market and causes an equity-lead specific to positive macro news. In the event of bad equity market news, conversely, CDS prices rise immediately since in this case rapid adjustment is in the interest of dealers.

In support of this explanation we find that the CDS-lag and its news-specificity are related to various firm-level proxies for hedging demand. A second implication of our explanation is that in periods of high informational asymmetry the CDS market's lag should be longer –

because dealers then have greater pricing power vis-à-vis uninformed investors. We show that when information asymmetry is high – identified by either larger than usual bid-ask spreads or in days immediately preceding major macroeconomic news announcements – CDS returns are particularly sensitive to lagged positive equity returns.

Summarizing, this paper contributes to our understanding of the informational efficiency of markets by showing that price discovery can be predominantly news-specific: for equity and CDS markets there is a stark and robust asymmetry in the pricing of new information. We attribute this asymmetry to the fact that traders in one market may only be informed with respect to some type of innovation.